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# 3

## *The failure of corporate governance and the limits of law: British banks and the global financial crisis*

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The global financial crisis demonstrated the fragility of the widely accepted faith in prevailing corporate governance ideas and the adequacy of legal mechanisms that were available to buttress these ideas. This was very evident from the fate of British banks after the failure of Northern Rock plc in late 2007 and the subsequent government action to rescue other leading British banks (Treasury Committee, 2008b). After more than two decades of debate in regard to the improvement of corporate governance mechanisms in Britain, it became evident that many of the ideas that had been advanced during this debate have been found to be wanting and were in need of revision or even replacement; these earlier debates had largely sought to legitimize a self-regulatory approach to corporate governance and a minimal involvement of governments in markets.

This corporate governance rhetoric can be traced back at least to the Cadbury Committee and subsequent inquiries which have helped to fashion the architecture of British corporate governance (Cadbury, 1992). These debates raised expectations in regard to the effectiveness of corporate governance codes, the monitoring roles of boards and especially of non-executive directors, the roles of institutional investors, and the effectiveness of shareholders in being able to deal with major governance matters requiring attention (Greenbury, 1995; Myners, 2001; Higgs, 2003). The recent Walker Review of corporate governance in UK banks has sought to salvage many of these prevailing ideas by looking for best practice solutions to strengthen the largely self-regulatory corporate governance structures (Walker, 2009).

This approach followed a broadly Anglo-American tradition of seeking to minimize the involvement of government in markets and led to the development of international movements to replicate this rhetoric in the fabric of international corporate governance structures; this is best illustrated in the development of the OECD's Principles of Corporate Governance and the replication of such codes widely



around the world (OECD, 1999; OECD 2004). The OECD has more recently also looked for best practice mechanisms to strengthen corporate governance in banking institutions (OECD, 2010). In many countries, and particularly in the UK with its Combined Code on Corporate Governance (2006), the faith in these ‘soft law’ corporate governance strategies was matched by a minimal development of legal rules, such as those regarding the issue of derivatives, and by a regulatory approach to markets which accepted the prevailing orthodoxy that markets could best be left to regulate themselves.

The effect of the minimal regulatory influence of the state over financial markets was amplified by the role of government in promoting London as a leading financial centre and in encouraging foreign banks and financial institutions to base themselves in this city because of the low level of legal intervention that could be expected. As a consequence, London attracted many of the riskier financial operations of foreign firms such as Lehman Brothers and AIG, as well as securities fraudsters such as Bernard Madoff.<sup>1</sup> The discussion of these other catastrophic failures is, however, beyond our scope here.

This chapter will look at evidence that has emerged from the recent financial crisis regarding the weaknesses in prevailing corporate governance prescriptions; it will also examine failures in regard to legal mechanisms that had been seen as buttressing these largely private corporate governance ideas. It will focus mainly upon the UK, although similar findings could be made in regard to other markets, such as the United States and Germany (see further, Acharya *et al.*, 2009; Hopt, Kumpan and Steffek, 2009; Posner, 2009; Mulbert, 2010). Unfortunately, there is insufficient space to deal with wider issues, such as the development of effective regulatory structures to deal with financial markets and the wider, largely politically driven, imperative to support London as a major financial centre. This is because an adequate treatment of these issues does, to a significant degree, require an international approach that is beyond the capacity of any one jurisdiction (see further, Treasury Committee, 2009d).

## **The wider context of UK corporate governance**

To understand why it was possible for such catastrophic failures of major British banks to occur so suddenly it is useful to draw attention to the interweaving of three prevailing forces. First, the



ideological belief in the inherent superiority of self-regulation of financial markets was deeply entrenched in both the public and private sectors and undermined effective public oversight of markets. Secondly, the consequential belief that there was little, if any, need for government monitoring of these markets had the consequence that public legal institutions were either underdeveloped or undermined. Thirdly, the political imperative to develop and maintain the position of London as a major financial centre meant that political pressure could also be brought to bear against intrusive regulations or regulators.

There is no doubt that there are good arguments for all of these beliefs. It is also true that any effective corporate regulatory regime must depend heavily upon corporations being committed to maintaining appropriate governance standards and values as part of their corporate culture. It is clearly unrealistic to rely exclusively upon state intervention and monitoring in the regulation of complex financial markets; but this should not mean that government should retire from the field and merely act as a cheerleader on the sidelines of the marketplace.

Alternatives to governmental regulation, such as the reliance upon private sector bodies, such as rating agencies, to evaluate the quality of financial products such as derivatives, face other problems, such as possible conflict of interest; indeed, it has been argued that rating agencies have played a significant role in generating the financial crisis (see further, Coffee, 2009). Similarly, professional gatekeepers have also failed effectively to restrain abuses in accounting practices (as we saw with the collapse of Enron) or to ensure that directors acted properly (see generally, Armour and McCahery, 2006).

Professional gatekeepers (such as auditors and lawyers) have been seen as playing an important role in ensuring corporate integrity and their failure to prevent misconduct (often due to conflicts of interest) have undermined their effectiveness (see generally, Coffee, 2006; Fuchita and Litan, 2006; Dravis, 2007, pp. 125–46). Even internal corporate risk monitors within banks who were charged with the responsibility of risk assessment proved ineffective when faced with euphoric market situations and pressures from the sell side of banks. This was most graphically illustrated by the failure of Paul Moore in HBOS to effectively communicate the gravity of the risks that were being taken by the bank.<sup>2</sup>



Finally, the political appeal of hosting a major financial centre needs to be balanced by the risks that excesses in such centres may lead to the need to impose heavy financial burdens on taxpayers who may be called upon to rescue failed financial institutions on the grounds that their survival was essential to the maintenance of stability in markets.

Maintaining market stability and avoiding the spread of contagion from any failed financial institution are primary considerations in times of market crisis, so that emergency action taken to rescue failing institutions may often not be well thought through and may in due course be seen as being too irksome. For this reason, effective corporate governance mechanisms cannot readily be constructed during crises, but crises do provide an opportunity to articulate more long-term solutions. This is because the evidence produced by such crises can be illuminating for corporate governance reformers.

### **Recent failures in British banking**

The decade or so leading up to the failure of Northern Rock plc in late 2007 had seen a massive transformation in the size and nature of British banking. Long-established building societies, like Northern Rock, had demutualized and set their sights upon rapid expansion; this was facilitated by the ready availability of substantial funds from foreign investors from as far afield as East Asia and the Middle East. Little consideration was given to the possibility that the availability of funds might suddenly dry up, as occurred in September 2007.

In May 2009, the House of Commons Treasury Committee reviewed the failure of British banking since September 2007 and noted that as a result of the financial crisis:

Five of the nine FTSE 100 banks in March 2007, Bradford & Bingley, HBOS, Lloyds TSB, Northern Rock and RBS, are now partly or wholly in public ownership. None of the four demutualised building societies, Alliance and Leicester, Bradford & Bingley, HBOS and Northern Rock, now exists as a stand-alone bank in its own right. Thousands of jobs in the financial services sector have been lost . . . It is hard to estimate what will be the eventual cost to public funds of the banking crisis but the damage will be substantial and long-term. (Treasury Committee, 2009b, p. 7)

But prior to September 2007, the ready availability of borrowed funds during these boom years meant that some banks, such as the Royal



Bank of Scotland (RBS), Northern Rock and HBOS, rapidly expanded to become significant national and international players. In the case of RBS, it was to become a major international player as a result of the ease with which funds could be borrowed; this expansion was largely achieved by resort to corporate takeovers (such as the ill-fated acquisition of Dutch bank ABN Amro in 2007 by RBS, Fortis and Santander<sup>3</sup>) as well as to the development of new and more risky lines of business.

This led to a change in the dominant business model that was used by these banks and financial institutions; in the case of a bank's mortgage business, instead of relying on the traditional 'originate to hold' model, whereby banks would write mortgages and then hold these until lenders had paid their mortgages out, banks moved to an 'originate to distribute' model in which they would repackage or securitize mortgages and often transfer these to off-shore special purpose vehicles that would then sell these securitized assets to investors. It was believed that the use of securitization was a way of limiting the risk faced by banks by taking these securitized products off their balance sheets by dispersing risk among other investors. But, as the FSA Chairman, Lord Turner, had observed, '[t]his analysis has proved wrong. Rather than improving system resilience, the development of securitised credit has ended up producing the worst financial crisis for a century' (Turner, 2009).

The dangers presented by these new business models were not properly understood in view of the short-term horizons upon which prevailing risk models had been built (Taleb, 2007). The misplaced reliance upon faulty mathematical models also encouraged even greater risk-taking by issuers of new financial products (Tett, 2009). Accentuating this risk-taking was the system of distorted incentives, such as large bonuses, which encouraged investment divisions of banks to develop and distribute new derivative products. The system of rewarding bankers by the payment of bonuses based on short-term performance often failed to have regard to long-term risks that were inherent in the products that had been sold by these banks (see further, Treasury Committee, 2009c).

This conduct was built upon a conception of markets as ultimately being rational and efficient, assumptions that were found to be faulty; the concept of 'irrational exuberance' has been used to characterize behaviour during market bubbles (Shiller, 2000; Fox, 2009). However,



despite the prevailing view of the inherent rationality of markets, some economists such as Minsky (1986) and Kindleberger and Aliber (2005) had long known that financial markets were susceptible to crises during periods of speculative booms. But, as Richard Posner (2009, pp. 259–60) has argued, contrary voices such as these were often lost or submerged during the boom years due to the ‘overinvestment by economists, policymakers, and business leaders in a free-market ideology that opposes aggressive government interventions in the operations of the economy’.

These ideologies were very influential in the UK where deregulatory and *laissez-faire* rhetoric was embraced with enthusiasm by both government and business. As Chancellor of the Exchequer, Gordon Brown championed risk-taking and the ‘light touch’ regulatory environment that London provided. On the eve of the collapse of financial markets in 2007, in addressing civic leaders and members of the financial community in London, Chancellor Brown confidently observed:

Over the ten years that I have had the privilege of addressing you as Chancellor, I have been able year by year to record how the City of London has risen by your efforts, ingenuity and creativity to become a new world leader. Now today over 40 per cent of the world’s foreign equities are traded here, more than New York:

- over 30 per cent of the world’s currency exchanges take place here, more than New York and Tokyo combined,
- while New York and Tokyo are reliant mainly on their large American and Asian domestic markets, 80 per cent of our business is international, and
- in a study last week of the top 50 financial cities, the City of London came first.

So I congratulate you Lord Mayor and the City of London on these remarkable achievements, an era that history will record as the beginning of a new golden age for the City of London.<sup>4</sup>

This exuberant attitude had led the UK in 2002 to confer an honorary knighthood upon the former chairman of the US Federal Reserve, Alan Greenspan, the architect of the low level of regulatory intervention in financial markets, for his ‘contribution to global economic stability’.<sup>5</sup> Two years later, the Chief Executive of the



Royal Bank of Scotland, Fred Goodwin, was also awarded a knighthood, although there were later calls for the removal of this knighthood following the collapse of RBS.<sup>6</sup>

More significantly, the UK had deliberately chosen an approach to market regulation that was ‘principles-based’ and used ‘light-touch’ regulatory methods. This model had been championed as a more effective response to the kinds of market abuses that had led to the passage in 2002 of the Sarbanes-Oxley Act in the United States following the Enron and Worldcom failures. Critics have claimed that the superiority of the UK principles-based system of market regulation was not well founded (Kershaw, 2005). In contrast, the success of this strategy had been asserted by Chancellor Brown in his 2007 Mansion House speech, but the weakness of this strategy was soon evident after the Financial Services Authority sought to explain its failure to prevent the failure of Northern Rock. The FSA’s internal audit presented a damning account of its failures as a regulator.<sup>7</sup>

The Treasury Committee of the House of Commons, when reviewing the failure of Northern Rock, was also critical of the failure of the tripartite regulatory authorities (consisting of the FSA, the Bank of England and the Treasury) to act quickly enough in the face of Northern Rock’s difficulties in September 2007; these bodies also seemed to lack a clear leadership structure, although the Chancellor was said to be ultimately in control (Treasury Committee, 2008a, pp. 104–13).

The FSA was subsequently to largely abandon exclusive reliance upon its ‘light-touch’ and ‘principles-based’ approach to regulation as being unsuitable in regard to financial markets as they had come to evolve in London. Instead, the FSA moved to what it was to call ‘the Intensive Supervisory Model’. Hector Sants, the FSA Chief Executive, explained the rationale for this model:

Historically, the FSA characterised its approach as evidence-based, risk-based and principles-based. We remain, and must remain, evidence- and risk-based but the phrase ‘principles-based’ has, I think, been misunderstood. To suggest that we can operate on principles alone is illusory particularly because the policy-making framework does not allow it. Europe, in particular, has a particular penchant for rules and in any case in a number of key areas such as prudential regulation they are indeed necessary . . . Furthermore, the limitations of a pure principles-based regime have to be



recognised. I continue to believe the majority of market participants are decent people; however, a principles-based approach does not work with individuals who have no principles.<sup>8</sup>

From the above it is clear that external corporate regulatory structures were poorly attuned to effectively monitoring ‘high impact’ firms such as Northern Rock. UK laws were also poorly structured to deal effectively with failing banks, leading to a scramble to draft new special resolution regimes in an effort to rescue failing banks and to maintain market stability (see further, Tomasic, 2009b). In addition, it was recognized that other legal remedies, such as the company law obligations of directors’ provisions and shareholder rights’ mechanisms were not adequate when dealing with financial crises such as that involving Northern Rock and other British banks (see further, Tomasic, 2009a; Tomasic, 2009c).

This then leads us to look more closely at the internal corporate governance structures within British banks. This was a matter that was touched upon in the January 2008 report of the Treasury Committee that looked into the run on Northern Rock, when criticisms were made of the lack of adequate banking qualifications of the Northern Rock Chairman and CEO. The Treasury Committee noted that the failure of Northern Rock was both a failure of the FSA as regulator as well as a failure of the Northern Rock board of directors (Treasury Committee, 2008a, pp. 33–4).

It pursued these themes further in a number of reports in the following year (Treasury Committee, 2009a; Treasury Committee, 2009d). The theme of corporate governance failure was to be further pursued in the Committee’s later reports and was taken up especially in the November 2009 Walker Review into corporate governance in UK banks (Walker, 2009). It is appropriate that we now turn to look more closely at some of these corporate governance issues.

### **A case study: corporate governance failures in Northern Rock plc**

In many ways, the rise and fall of Northern Rock plc may be seen as reflecting many of the forces at work in the UK financial system in the lead up to, and in response to, the global financial crisis.<sup>9</sup> It was certainly not the biggest casualty of the crisis, as Royal Bank of Scotland and HBOS had greater financial difficulties. It was, however, the only bank to be fully nationalized by the UK Treasury, although



larger amounts of public money were allocated to the rescue of some of the other failing UK banks.

Some UK banks, such as Barclays and HSBC, managed to avoid having to call upon the Treasury for funds to sustain them,<sup>10</sup> but other banking names have now disappeared, such as Bradford & Bingley and Alliance and Leicester, which were acquired by the Spanish bank Santander and added to Santander's other British banking assets. Some major building societies, such as Scotland's largest building society, the 140-year-old Dunfermline Building Society, were absorbed by a larger domestic financial institution.<sup>11</sup> A recapitalized Northern Rock is also likely to be sold off as market conditions improve.

Like many of the institutions that had struggled in the face of the global financial crisis, Northern Rock was a former mutual, having been set up as a building society in 1965 following the merger of two older building societies that had originally been established in 1850 and 1865 respectively.<sup>12</sup> In 1965 the Northern Rock Building Society became the largest building society in Newcastle. It then grew rapidly, largely as a result of the acquisition of other building societies, and this saw its assets double to over £1 billion in 1983.

After this time the building society set up a commercial finance division and moved into commercial lending. In 1994 it acquired the North of England Building Society, based in Sunderland; this was significant as it added 43,000 new borrowers and over £1.5 billion in assets, giving Northern Rock assets of over £10 billion and making it one of the top ten players in the industry. As one observer has noted: '[o]ver four years it had increased its size threefold, its profits fourfold and had halved its management expense ratios' (Walters, 2008, p. 6).

In 1997 Northern Rock demutualized and became a listed public company; this allowed it to raise more capital from markets.<sup>13</sup> All qualifying members of the mutual received 500 shares each and became shareholders in the new company. The business grew on the back of competitive pricing of its products and a narrow margin between what it paid for funds and the amount that mortgage borrowers paid it in interest. Although it was called a bank, Northern Rock did not offer a full range of banking services and tended to focus mainly upon residential and commercial mortgages and unsecured personal loans. In the first half of 2007 it wrote £10.7 billion in residential mortgages and this represented 18.9 per cent of UK net mortgage lending.



The bank's growth had not been funded by an expansion in its retail deposits but through reliance upon wholesale markets for interbank lending and by use of securitization (National Audit Office, 2009, p. 13). It had also not been greatly funded by equity capital-raising on the stock market. Nevertheless, by 2007 Northern Rock had become the fifth largest mortgage lender in the UK. However, it was under pressure due to its low levels of capitalization. It had almost the lowest level of market capitalization with only £4.8 billion in capital raised on stock markets on 2 April 2009.<sup>14</sup> In contrast, the market capitalization at that time of other leading UK banks was much higher: £31.6 billion for Lloyds-TSB, £39.30 billion for HBOS, £47.1 billion for Barclays, £62.8 billion for RBS and £103.1 billion for HSBC (Treasury Committee, 2009b, p. 7).

In March 2007, Northern Rock was forced to sell its profitable commercial finance division as the new Basel II Accord, introduced earlier that year, had imposed higher capital adequacy requirements for commercial lending than for mortgage-based lending. In June this commercial finance business was eventually sold for £1.6 billion to Lehman Commercial Mortgage Conduit Limited – an affiliate of the American investment bank Lehman Brothers. In the meantime, interest rates continued to rise; this was a problem for Northern Rock as it relied heavily upon borrowing funds from the money market at the interbank rate (LIBOR). This created a problem as most of Northern Rock's mortgage lending to its customers was tied to the Bank of England base rate, which was lower than the rate at which it sourced funds.

This pressure caused Northern Rock to issue a profit warning to the London Stock Exchange at the end of June 2007. This led to a 12 per cent drop in the bank's share price or a 30 per cent drop in prices since February. At the same time Northern Rock received a Basle II waiver, which meant that only 15 per cent of its funds had to be available to support its residential mortgages. However, in a company that sourced 75 per cent of its funds externally, this left Northern Rock 'particularly exposed' due to the severe shortages of capital that it faced (Walters, 2008, p. 45). But the bank did not seem to be too concerned about this problem.

This was characteristic of similar attitudes in other banks at this time, which continued to trade optimistically (see Treasury Committee, 2009b, pp. 7–8). This extraordinary lack of restraint in the face of signs that the market was beginning to collapse was found in other



banks such as HBOS and RBS, which continued to do very risky deals, despite the warnings (Treasury Committee, 2009b, pp. 20–4).

On 9 August 2007 interbank lending stopped suddenly due to fears that arose from an announcement by the French bank BNP Paribas that it would suspend three of its asset-based securities funds because of concerns that these could no longer be properly valued due to difficulties that were emerging in the US subprime mortgage market (Brummer, 2008, pp. 55–74). This followed hard on the heels of revelations of severe problems with three German banks on 2 August.<sup>15</sup> In one insider account from within Northern Rock:

This announcement sent shock waves through an already sensitive market and it became evident to the board at Northern Rock that it would face severe problems if the markets were to stay frozen for long. The problems were especially severe for Northern Rock because its funding model required mortgage-backed securities and plain mortgages to be securitised, and its next securitisation was scheduled for September 2007. (Walters, 2008, p. 53)

The market freeze of 9 August 2007 was similarly described by one financial journalist:

The events of Thursday, 9 August, had devastating consequences for Northern Rock as it felt the full blast of the credit crunch. The bank's risk committee, headed by Sir Derek Wanless, had failed to act as a restraining force on the strategy of the executive members . . . Now that the credit markets around the world, on which it depended for 75 per cent of its funding, were freezing up it found itself caught in a perfect squeeze, unable to fund the loans on its mortgage book, many of which had been sold too cheaply. (Brummer, 2008, p. 67)

The senior officers of Northern Rock were also severely shocked by the multiple failures that occurred at this time. As the Commons Treasury Committee observed:

Mr Applegarth [the CEO] told us that Northern Rock had wrongly 'believed that high-quality assets and transparency [were] the way to maintain liquidity.' Sir Derek Wanless [a non-executive director] told us that Northern Rock's 'first line of defence [was] good credit quality . . . Northern Rock had not foreseen all its funding markets closing simultaneously, as happened after 9 August . . . The idea of all markets closing to Northern Rock was repeatedly characterised to us by Northern Rock officials as 'unforeseeable'. (Treasury Committee, 2008, p. 16)



September did indeed prove a decisive moment for Northern Rock; on the 13th the Bank of England's emergency loan to Northern Rock was made public as a result of a leak to the BBC; this precipitated a bank run by Northern Rock depositors. As one financial journalist observed:

Within minutes of the BBC bulletin, consumers began logging on to Northern Rock's website and withdrawing their cash. The website then crashed, fuelling panic. The next morning, Northern Rock savers flocked to the bank's branch offices, and pictures of terrified savers in a long line in front of the bank beamed on to computers, television screens . . . across the world. By mid-morning, a full-scale bank run was under way. (Tett, 2009, p. 229)

The board of Northern Rock finally announced on 17 September that the Bank of England had given it a guarantee of 100 per cent of its deposits. A number of concerns had led the Bank of England to keep its support for Northern Rock secret as it examined legal issues connected with the provision of state support. Previously, the Bank of England had been reluctant to provide support to private banks because of arguments around the problems of moral hazard that had often been used to prevent government support for failing companies; these economic arguments were to be almost universally discarded as the financial crisis gathered momentum.

The corporate governance problems facing Northern Rock were closely examined by the Treasury Committee of the UK House of Commons which concluded that:

The directors of Northern Rock were the principal authors of the difficulties that the company faced since August 2007. It is right that members of the Board of Northern Rock have been replaced, though haphazardly, since the company became dependent on liquidity support from the Bank of England. The high-risk, reckless business strategy of Northern Rock, with its reliance on short- and medium-term wholesale funding and the absence of sufficient insurance and a failure to arrange standby facility or cover that risk, meant that it was unable to cope with the liquidity pressures placed upon it by the freezing of international capital markets in August 2007.

The Treasury Committee went on to explain the nature of this governance failure when it added that:

Given that the formulation of that strategy was a fundamental role of the Board of Northern Rock, overseen by some directors who had been there



since its demutualisation, the failure of that strategy must also be attributed to the Board. The non-executive members of the Board, and in particular the Chairman of the Board, the Chairman of the Risk Committee and the senior non-executive director, failed in the case of Northern Rock to ensure that it remained liquid as well as solvent, to provide against the risks that it was taking and to act as an effective restraining force on the strategy of the executive members. (Treasury Committee, 2008a, p. 19)

In its response to these findings, the UK government agreed that the primary responsibility for minimizing risks and preventing other problems lay with the bank's directors. Criticisms were levelled at a number of key features of its board; first, the chairman of the board (Dr Matt Ridley, a well-known scientist) was seen to lack appropriate experience and expertise to chair a major banking institution; secondly, the chief executive of the bank (Adam Applegarth) was criticized on a number of counts; thirdly, the board itself did not have significant levels of banking expertise; finally, its independent or non-executive directors seem to have failed to provide the kinds of checks and balances that it was said that such directors might provide to restrain an overly adventurous chief executive. Let us look at some of these concerns more closely (see further, Tomasic, 2008b, pp. 330–5).

As we have seen, the House of Commons Treasury Committee laid responsibility for this failure to respond to the bank's changing risk situation squarely on the shoulders of its board.<sup>16</sup> The senior independent director of Northern Rock, Sir Ian Gibson, had argued before the Committee, in the board's defence, that it had sought advice from the FSA and the UK Listing Authority on the state of its business model; it also sought advice from its own legal advisors, and as a result the Northern Rock board was 'fully satisfied that we did follow the best advice and follow[ed] it to the letter' (Treasury Committee, 2008a, p. 19). This confidence is in stark contrast to the subsequent findings of the Treasury Committee and many of those experts that it relied upon.<sup>17</sup> Whether this effort to seek external advice is enough to satisfy the business judgment rule and principles of reliance is open to question.

It is interesting to refer to wider reactions in the financial media to the patterns of behaviour at Northern Rock, which were apparently sanctioned by the Northern Rock board. This might help to better assess what would be seen as reasonable action on the part of the board. Some corporate governance authorities have accused the



Northern Rock board of lacking in due diligence.<sup>18</sup> Other comments have focused on the differing roles of executive and non-executive directors, as well as on the role and skills base of the bank chairman and its CEO. Writing generally about the difficulties facing board members, Paul Myners, at the time the City Minister and a former member of the UK Financial Reporting Council, stressed the increasing importance of corporate governance in regard to banks:

Proposals to overhaul the banking system have largely ignored the governance of our banks. But if other reforms are to have any traction, it is essential to shake up the boardrooms that oversee the rest of the operation. First, board members should never forget that the most vital part of their job is to challenge executives . . . Are board members asking the right questions and with enough persistence? . . . The business of banking is exponentially more complicated than a generation ago, and the panel [the board] guiding it must be able to follow its dealings. At the very least the chairman and senior independent director or chairman of the risk committee should have recent and relevant banking experience. (Myners, 2008, p. 15)

In regard to non-executive directors, Ruth Sunderland, writing in *The Observer*, noted that:

Northern Rock's downfall highlights persistent weaknesses in corporate governance, not just there but at other blue-chip companies. The independent directors, who are supposed to act as a check on executive folly, did not restrain Adam Applegarth, the chief executive, from his turbo-charged business model, which was a bit like putting a Ferrari engine into a Micra.

Sunderland went on to ask why none of the non-executive directors 'seems to have made the simple inquiry as to why a modest mortgage bank in Newcastle upon Tyne was playing at the casino end of the capital market'.<sup>19</sup> But Anthony Hilton, writing in September 2007, thought that the non-executive directors of Northern Rock were 'not lightweight people' as they had considerable experience in the financial services industry and yet they either did not see the risks that the bank was running or, if they did, they were unable 'to persuade the management to be more prudent'. He added that some non-executive directors may find it difficult to seek to restrain an overly zealous CEO who was at the same time being cheered on by the wider business community.<sup>20</sup> This was a point emphasized by Hilton when he wrote: 'Adam Applegarth, the [Northern Rock] chief executive, was a much-admired man in the fund management community until last month. What chance do



non-executive directors have to rein him in when the entire fund management community is on the other side urging him on?' He added pointedly that '[w]e might conclude that the problem lies not in the quoted companies, but among the analysts and institutional shareholders who in their thirst for rewards too often drive executives to those very excesses of risk which end in tears.'<sup>21</sup> It could also be argued that the board may have been encouraged to have less to fear of the risks inherent in its business strategy because these risks were being securitized and then passed on to Granite, Northern Rock's special purpose vehicle.

As it turned out, this was not as effective a way of avoiding these risks as they might have expected. In any event, it seems from the comments of independent director Sir Ian Gibson that the board would seek shelter in legal arguments to the effect that they acted reasonably and that they took advice from appropriate experts. However, some courts have become increasingly uncomfortable with arguments upon reliance where directors might be expected to know better or to be more diligent.<sup>22</sup>

The old view of a director's standard of care and diligence, as expressed by Romer J in *Re City Equitable Fire Insurance Co Ltd*,<sup>23</sup> has come to be criticized with the rise of community expectations concerning the qualities that directors should bring to the boardroom. In developing a standard of 'reasonable care' to be followed by directors, Romer J had drawn upon the discussion of the notion of reasonable care in the nineteenth-century decision in *Overend & Gurney Co v. Gibb*. This was, of course, a case involving a company that was at the heart of the last major run on a British bank (see further, Collins and Baker, 2003, pp. 86–91). In that case it was said:

. . . whether or not the directors exceeded the powers entrusted to them, or whether if they did not so exceed their powers they were cognisant of circumstances of such a character, so plain, so manifest, and so simple of appreciation, that no men with any ordinary degree of prudence, acting on their own behalf, would have entered into such a transaction as they entered into?<sup>24</sup>

This view of the notion of reasonable care has been echoed to some degree by the New South Wales Court of Appeal in *Daniels t/as Deloitte Haskins & Sells v. AWA Ltd*.<sup>25</sup> However, this Court went on to call for a higher standard of care than that propounded by Romer J and called for a more active engagement by directors in the scrutiny of company decisions.



Influenced by more objective standards for directors of companies facing insolvency, there has been a movement in some courts to adopt a more objective standard of care than was evident in earlier cases such as *Re City Equitable*. This may be illustrated by the view taken in the UK of the duty of care owed by a director.<sup>26</sup> For example, Professor Davies has noted:

. . . the change over time in the type of person appointed to the board has also led to a shift of view within company law about the appropriate standard of care for directors . . . The primary focus of the law's scrutiny is on whether the board took reasonable steps to inform itself before it took the decision in question and not on whether the substantive decision taken was reasonable. (Davies, 2002, pp. 155–7)

In the Australian case of *Daniels v. Anderson*, the NSW Court of Appeal sought to go beyond early twentieth-century British case law and drew upon US authority to update legal principles derived from Britain on the extent to which directors could rely upon others when making decisions.<sup>27</sup> However, Northern Rock shareholders were not able to obtain much comfort from these developments as there remained some doubt in the UK that legal actions against its directors would be successful.

Following its nationalization, on advice from their lawyers, the new controllers of Northern Rock therefore decided that there were insufficient legal grounds to pursue such an action against the former bank directors.<sup>28</sup> When Northern Rock shareholders subsequently sought compensation for the loss of their shares, as a consequence of the forced nationalization of the bank, their causes of action did not focus upon the duties of the directors of Northern Rock, but unsuccessfully relied largely on human rights grounds concerned with the unfair misappropriation of their property by government (see further, Tomasic, 2009c).

In light of this discussion of evolving legal principles regarding the appropriate duties of directors, it is interesting to note the level of qualifications held by members of the board of Northern Rock; this had been discussed by the Commons Treasury Committee and has been the subject of pointed comments in the press. Although the chairman of Northern Rock's Risk Committee was seen as being 'an extremely experienced banker', the report of the Treasury Committee found:



We are concerned that the Chief Executive of Northern Rock [Mr Adam Applegarth] was not a qualified banker, although of course he has significant experience. The Financial Services Authority should not have allowed nor even again allows two appointments of a Chairman and a Chief Executive to a 'high-impact' financial institution where both candidates lack relevant financial qualifications; one indication that an individual has been exposed to the relevant training is an appropriate professional qualification. Absence of such a qualification should be a cause of concern. We therefore recommend that the FSA undertake an urgent review of the current qualifications of senior directors in financial firms . . . (Treasury Committee, 2008, pp. 33–4)

The qualifications of the former chairman of Northern Rock, Dr Matt Ridley, also did not escape comment; it was noted in the *Financial Times* that he was a zoologist and a successful science writer (Myners, 2008, p. 15). He had joined the board of Northern Rock in 1994 and then served as non-executive chairman from 2004 until 2007; he resigned after being criticized in Parliament for harming the reputation of British banking and for lacking financial experience.<sup>29</sup> His aristocrat father (Viscount Ridley) had previously been chairman of the bank from 1987 to 1992 and had sat on the board for three decades. It is not a strong defence for the board to say that the FSA had sanctioned actions taken by Northern Rock, especially when one reads the heavy criticism of the role of the FSA in this collapse that was made in the House of Commons (Treasury Committee, 2008, p. 34).

However, industry leaders since the time of Walter Bagehot (1873) have for some time called for the adoption of a higher standard of care than that which UK courts have been prepared to articulate; the judicial view was that it was the responsibility of Parliament to state any higher duty of care and not the courts. For example, in more recent times, Sir Adrian Cadbury, writing about the role of the chairman of a public listed company, highlighted the rise in expectations of directors that has occurred and went on to point to the need for the training of directors; he pointed to paragraph A.2.1 of the then UK Combined Code on Corporate Governance which stated that 'every director should receive appropriate training on the first occasion that he or she is appointed to the board of a listed company, and subsequently as necessary' (Cadbury, 2002, p. 24). Cadbury went on to discuss risk management and the role of the board in this regard and noted that:



A key point is that companies are continually having to adjust their plans and strategies in the light of a changing competitive environment and thus the risks they face, and the priorities to be assigned to them, are continually changing as well . . . It is for boards to set internal control policies and to assure themselves that they are working as they should. It is the job of management to put those policies into effect. (Cadbury, 2002, p. 220)

Interestingly, the government-appointed Walker Review was also to criticize the standards of directors and called for amendments of the Combined Code to require them to be more actively involved in monitoring company matters. Walker, however, refrained from seeking to express this higher standard in legislative form, preferring the voluntary ‘comply or explain’ model that had prevailed for some time. In the context in which domineering CEOs were able to influence boards to adopt excessively risky strategies, Walker called into question patterns of behaviour on British bank boards and noted that: ‘The most critical need is for an environment in which effective challenge of the executive is expected and achieved in the boardroom before decisions are taken on major risk and strategic issues’ (Walker, 2009, p. 12).

Walker’s preferred solution was to strengthen corporate governance mechanisms that were already in place because of the fact that many corporate governance problems were ‘organic, dynamic and behavioural’ and better dealt with by non-legal mechanisms (Walker, 2009, p. 28). This view is only partly correct, as there is much scholarly research to show that sole reliance on private regulatory enforcement alone will fail to secure improved regulatory objectives (see generally, McBarnet *et al.*, 2007; Braithwaite, 2008).

In any event, Walker focused on making improvements, such as in the composition of the board, obtaining greater time commitment by non-executive directors to their board duties, seeking a more active involvement of the chairman, increased board-level engagement in risk oversight and greater involvement of shareholders (and especially institutional shareholders) in discharging their responsibilities as owners. This has led the UK Financial Reporting Council to draft a Stewardship Code and to review provisions of the former Combined Code of Corporate Governance (see further FRC 2009; FRC 2010). The key question here will be whether these ‘soft law’ solutions will be sufficient.

It is too early to say whether such corporate governance changes are likely to prevent the collapse of another leading banking institution. The collapse of Northern Rock clearly highlighted major deficiencies



in the internal and external regulation of British banks and identified corporate governance issues as being important reasons for this failure. The academic literature would suggest that there is more room for improvement than that identified in the Walker Review. But the fact that the FSA has become more active in regulating British banks and financial institutions is a major departure from earlier patterns of governmental regulation of this sector.

### Some conclusions

The failure of so many British banks during the global financial crisis has highlighted the centrality of corporate governance issues. These have widely been perceived to have been important in explaining why banks failed to respond to the risks that were to cause them to fail. In part, this failure has been attributable to an uncritical adherence to market self-regulation; in this context it was widely considered that soft-law codes of corporate governance were more effective than legislation or government regulatory action. To some degree this view has been echoed in the academic literature, which has pointed to the limits of law and the centrality of corporate culture in explaining corporate conduct (see further, Stone, 1975).

Although formal legal rules and government regulation alone have limitations in being able to ensure corporate accountability, the simple pursuit of self-regulatory or soft-law mechanisms is not adequate either. This has been demonstrated by recent events, where the virtual withdrawal of government action in fostering improved corporate governance has undermined the operation of self-regulatory strategies in British banks. It is clear that there is room for a range of mechanisms in achieving better corporate governance.

The failure of British banking regulation during the recent financial crisis calls for a more thoroughgoing review of existing corporate governance mechanisms. This applies both within banks and to bank boards in particular. It also calls for more effective external monitoring and control of corporate governance failures. Simply tinkering with the self-regulatory 'comply or explain' approach and renaming the Combined Code, are unlikely to be effective, especially in periods of market euphoria or booms. A history of successive bank and other corporate failures has demonstrated this lesson. As evident in the above discussion, the well-documented events



surrounding the failure of British banks such as Northern Rock, RBS and HBOS, to mention but a few, call for a more radical review of prevailing corporate governance and self-regulatory strategies than has occurred to date.

## Notes

- 1 In regard to Lehman Brothers and AIG see further McDonald, 2009; Sorokin, 2009 and in regard to the Ponzi scheme orchestrated by Bernard Madoff, see further Arvedlund, 2009; Markopolos, 2010.
- 2 See further, BBC News, 'HBOS whistleblower probe demanded', 11 February 2009, available at [www.news.bbc.co.uk/1/hi/uk\\_politics/7882119.stm](http://www.news.bbc.co.uk/1/hi/uk_politics/7882119.stm).
- 3 See further, Robbins, Mathieu, 'Was ABN the worst takeover deal ever?', *The Independent*, 20 January 2009, available at [www.independent.co.uk/news/business/analysis-and-features/was-abn-the-worst-takeover-deal-ever-1451520.html](http://www.independent.co.uk/news/business/analysis-and-features/was-abn-the-worst-takeover-deal-ever-1451520.html).
- 4 Speech by the Chancellor of the Exchequer, the Rt Hon. Gordon Brown MP, to Mansion House, City of London, 20 June 2007, available at [http://www.hm-treasury.gov.uk/press\\_68\\_07.htm](http://www.hm-treasury.gov.uk/press_68_07.htm).
- 5 BBC News, 'Alan Greenspan to be knighted', 7 August 2002, available at [www.news.bbc.co.uk/1/hi/business/2177814.stm](http://www.news.bbc.co.uk/1/hi/business/2177814.stm).
- 6 Churcher, J., 'Harman admits blunder over Goodwin's knighthood', *The Independent*, 4 March 2009; available at [www.independent.co.uk/news/uk/politics/harman-admits-blunder-over-goodwins-knighthood-1637347.html](http://www.independent.co.uk/news/uk/politics/harman-admits-blunder-over-goodwins-knighthood-1637347.html).
- 7 See further, Financial Services Authority, *The Supervision of Northern Rock: A Lessons Learned Review; Report*, March 2008, available at [www.fsa.gov.uk/pubs/other/nr\\_report.pdf](http://www.fsa.gov.uk/pubs/other/nr_report.pdf). See further, Tomasic, 2010.
- 8 Sants, H., 'Delivering intensive supervision and credible deterrence – Speech by Hector Sants, Chief Executive, FSA', 12 March 2009, Financial Services Authority, available at [www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0312\\_hs.shtml](http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0312_hs.shtml). Also see Wilson, H., 'Hector Sants calls time on FSA's "light touch" regulation', *Telegraph.co.uk*, 12 March 2010, available at [www.telegraph.co.uk/finance/newsbysector/banksandfinance/7431645/Hector-Sants](http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/7431645/Hector-Sants).
- 9 In addition to extensive material from public inquiries, much has been written about the failure of Northern Rock; see further Keasey and Veronesi, 2008; Lastra, 2008; Tomasic, 2008a and Tomasic, 2008b.
- 10 Banks like Barclays may, however, have obtained indirect benefit from the fact that the UK government has put in place an asset protection scheme to guarantee bank debts, although it had not, as such, signed up



to joining this scheme; see further, Farrell, S. and Aldrick, P., 'Barclays, the Houdini bank', *The Telegraph*, 13 February 2010, available at [www.telegraph.co.uk/finance/newsbysector/banksandfinance/7229425/Barclays-the-Houdini-bank.html](http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/7229425/Barclays-the-Houdini-bank.html). Also see generally, Power, H. and Coates, S., 'Barclays Bank comes out fighting against Treasury', *The Times*, 19 January 2009, available at [http://business.timesonline.co.uk/tol/business/industry\\_sectors/banking\\_and\\_finance/article5543107.ece](http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article5543107.ece).

- 11 See further: Wood, Z. and Hinsliff, G., 'Dunfermline Building Society to be broken up', *The Guardian*, 28 March 2009, available at <http://www.guardian.co.uk/business/2009/mar/28/dunfermline-building-society/print>.
- 12 These were the Northern Counties Permanent Benefit and Investment Building Society (formed in 1850) and the Rock Building Society (formed in 1865).
- 13 Other building societies to have demutualized included Abbey National (1989), Alliance & Leicester (1997), Birmingham Midshires (1999), Bradford & Bingley (2000), Bristol & West (1997), Cheltenham & Gloucester (1995), Halifax (1997), National & Provincial (1996) and Woolwich (1997); see further Treasury Committee, 2009b, p. 29.
- 14 Only Bradford & Bingley was weaker, with a market capitalization of £2.9 billion; see further, Treasury Committee, 2009b, p. 7.
- 15 These three German banks were IKB Deutsche Industriebank, Sachsen LB and West LB.
- 16 The following discussion draws in part upon Tomasic, 2008b, pp. 332–5.
- 17 These included the Governor of the Bank of England, who described the Bank's business strategy as being 'fundamentally flawed'. Also, Professor William Buiter from the London School of Economics pointed out that Northern Rock was 'clearly engaged in high-risk behaviour' and that 'its funding policies were reckless' – quoted in: Treasury Committee, 2008a, pp. 16–18.
- 18 This was the view of Professor Bob Garratt, a founding member of the Commonwealth Association for Corporate Governance; see further, Battersby, L., 'Don't turn your back on your board', *The Age*, 14 March 2008, available at <http://thebigchair.com.au/news/focus/don't-turn-your-back-on-the-board>.
- 19 Sunderland, R., 'Comment: King not only culprit in a right royal mess', *The Observer*, 23 September 2007.
- 20 It is too early to know what really motivated the Northern Rock non-executive directors as some, like Nichola Pease, insist that they do not want to talk about their experience at Northern Rock; see further, Burgess, K., 'Little time to talk about the Rock', *Financial Times*, 12 May 2008, p. 25.



- 21 Hilton, A., 'Why non-execs failed to rein in risk-taking at Northern Rock', *Evening Standard*, 20 September 2007.
- 22 There is a useful discussion of the development of this body of law in Austin, Ford and Ramsay, 2005 at pp. 250–7.
- 23 [1925] Ch 407.
- 24 (1872) LR 5 HL 480 at 486–7.
- 25 (1995) 13 ACLC 614.
- 26 This more objective standard may be seen in view of the duty of care owed by a director taken in two decisions of Hoffman LJ in the UK, see *Norman & Anor v. Theodore Goddard & Or* [1992] BCC 14 and *Re D'Jan of London Ltd* [1993] BCC 646. Also see further, Deane, 2001, pp. 65–70.
- 27 *Daniels (formerly practising as Deloitte Haskins & Sells) v. Anderson* (1995) 37 NSWLR 438.
- 28 'No legal action against Northern Rock bosses', *The Independent*, 14 October 2008. See the further discussion of the background considerations that would have explained this approach in Tomasic, 2009a, pp. 7–9.
- 29 Werdigier, J., 'Northern Rock chairman quits after criticism from lawmakers', *International Herald Tribune*, 19 October 2007.

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